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CITATIONS

STATUTES AND RULES:

In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 66

ISADORE BLAU, ETC., PETITIONER

v.

ROBERT LEHMAN, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

OPINIONS BELOW

The opinions of the court of appeals (R. 174-192 and 198-203) are reported at 286 F. 2d 786. The opinion of the district court (R. 149a-157a) is reported at 173 F. Supp. 590.

JURISDICTION

The judgment of the court of appeals was entered on December 20, 1960 (R. 193). A petition for rehearing was denied by the court *en banc* on February 21, 1961 [1] (R. 198-199). The petition for a writ of

[1] A request for *amicus curiae* participation by the Commission was also denied at that time (R. 198-199).

certiorari was filed on March 14, 1961 and granted on April 24, 1961 (R. 205). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

When a director of a corporation which has stock registered on a national securities exchange is also a partner in an investment banking firm which trades in the corporation's securities, may the corporation recover, under Section 16(b) of the Securities Exchange Act of 1934, the entire "short-swing" profits realized by the partnership or is recovery limited to the director-partner's proportionate ownership share of his firm's profits?

STATUTE INVOLVED

The portion of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), which is most directly involved provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. * * *

Sections 16(a) and 16(b) of the Securities Exchange Act of 1934 are set forth in full in an Appendix, *infra*, pp. 26-27.

STATEMENT

The stock of Tide Water Associated Oil Company ("Tide Water") is registered on the New York Stock Exchange. Petitioner, a stockholder of Tide Water, brought this action on behalf of the corporation under Section 16(b) of the Securities Exchange Act of 1934 to recover the profits realized by the firm of Lehman Brothers from purchases and sales of Tide Water stock within a period of less than 6 months. The complaint invoked the jurisdiction of the district court under Section 27 of the Securities Exchange Act of 1934.

Lehman Brothers is a partnership consisting of nineteen partners [2] and is a member of the New York Stock Exchange and other stock exchanges. The firm is engaged in the investment banking business, acts as a broker in securities, and trades in securities for its own account (R. 32a-33a). John A. Thomas, a partner of Lehman Brothers, was elected to the Tide Water board of directors on August 5, 1954, when his partner, John Hertz, resigned from the board. Mr. Thomas has served as a Tide Water director continuously since that date (R. 9a).

During the period October 8, 1954, to November 15, 1954, Lehman Brothers purchased for its own account 50,000 shares of Tide Water common stock (R. 43a-44a). On December 8, 1954, it converted these shares into a like amount of Tide Water preferred stock (R. 86a). The district court held that these acquisitions of the preferred stock constituted a "purchase" within

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[2] This is the number of partners named in the complaint (R. 4a-5a). Defendants' Exhibit D indicates there were 18 partners of Lehman Brothers at the end of 1955 when profits from the transactions involved were distributed (R. 119a-120a, 166a). The Commission's public records show that the firm now has 24 partners (SEC File No. 8-246-1).

the meaning of Section 16(b) and found that Lehman Brothers sold the preferred stock at a profit of $98,-686.77 within 6 months of these acquisitions (R. 156a).

Various partners in Lehman Brothers hold directorships in industrial and banking corporations (R. 33a).[3] While one partner testified that this practice has "[n]ot always" resulted from suggestions of the firm (R. 79a), John Hertz, the Lehman Brothers' partner who had been for many years Mr. Thomas' predecessor on the Tide Water board, testified in answer to the question whether it was (R. 65a) "the practice of Lehman Brothers to have some of its partners go on boards of corporations in order to further the interests of Lehman Brothers":

> Well, I surely joined Tide Water Company thinking it was going to be in the interests of Lehman Brothers.

At the last board meeting prior to his resignation, Mr. Hertz suggested that his partner, Mr. Thomas, be named to succeed him, partly because it would be in the interests of Lehman Brothers (R. 64a-65a). Mr. Hertz felt he did not have to tell his partner that serving on the board of Tide Water would further the interests of Lehman Brothers since Mr. Thomas "is a smart fellow." (R. 64a). After Mr. Thomas became a director of Tide Water, Lehman Brothers participated with two other firms in underwriting $50,000,000 of Tide Water bonds (R. 42a, 51a). Mr. Thomas was the partner assigned to the "Tide Water financing business" (R. 77a).

The purchases of Tide Water stock here involved

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[3] The Commission's public records currently disclose that partners of Lehman Brothers hold over 100 directorships (SEC File No. 801-364), many of which are in companies registered on national securities exchanges.

were authorized by William J. Hammerslough, the partner of Lehman Brothers in charge of its Portfolio Committee (R. 70a, 135a-136a). This Committee, which supervises the holdings of the firm, operates very informally and all members of the firm are sometimes invited to attend meetings (R. 70a, 81a). Although Mr. Thomas did not participate in the Committee discussions with respect to this purchase of Tide Water stock, he did have conversations with his partners concerning Tide Water affairs, suggesting "from time to time that I thought Tide Water under the new management was an attractive investment" and expressing "the opinion freely that I thought the management was first-rate, that the company would do well under that management" (R. 54a-56a). "Thomas spoke very highly of the management and prospects of" Tide Water to Mr. Hammerslough, with whom he had most extensive conversations concerning Tide Water (R. 55a, 69a).

When Mr. Thomas learned that purchases of Tide Water were being made by his firm he instructed the controller "to exclude me from any risk of the purchase or any profit or loss from the subsequent sale and to take the necessary steps to carry out my instructions." (R. 122a.) He and his partners agreed that he was to have no part in the transaction. (R. 123a).

After a trial without a jury, the district court dismissed the complaint against Lehman Brothers and entered judgment against Mr. Thomas for his proportionate interest in the partnership profits from the transactions involved, which amounted to $3,893.41 out of the total partnership profits of $98,686.77. No interest was allowed by the court (R. 158a). The court of appeals affirmed by a divided court (R. 174-192).

SUMMARY OF ARGUMENT

By providing in Section 16(b) of the Securities Exchange Act of 1934 that profits by insiders in "short-swing" transactions in stock of their corporations should be recoverable by the corporations, Congress intended to eliminate the "vicious practices" that resulted from trading by officers, directors and large stockholders on the basis of inside information. The legislative history shows that this trading was often conducted through organized "pools," in which members of investment banking firms played a prominent part. These practices were not only unfair to members of the investing public, with whom the insiders traded, but also led to manipulation of corporate affairs in order to promote trading profits for the insiders.

To allow recovery against the partner-director of only his share of his firm's profits from trading in the stock of his corporation, as did the majority below, gives only token effect to the legislative purpose of Section 16(b). With respect to large investment bankers such as the respondents' firm, the result is merely to reduce by a small percentage (in this case less than 4 per cent) the firm's total profits from transactions encompassed by Section 16(b), for the relationship between partners is such that one who must pay over the profits from one transaction will normally be otherwise compensated, perhaps by profits from the firm's trading in the stock of another corporation of which another partner is a director.

Section 3(a)(9) of the Securities Exchange Act defines "person" to include a partnership, making it clear that, for the purposes of the Act, a partnership group is to be treated as an entity, rather than as several individuals. Thus, a partnership is held to be

the insider when liability rests on a ten percent stockholding. Similarly, to carry out the intention of Section 16(b), the partnership should be treated as the "director" for purposes of liability under the Act in the circumstances of this case since the partner-director was, as a matter of law, acting for his partners.

In any event, the individual partner-director should be held liable for the entire profits from the transactions for under partnership law he is a co-owner of all property purchased with firm funds and of all profits realized from the sale of firm assets. Intra-partnership agreements as to the distribution of profits should not be permitted to control liability imposed by Congress for the protection of the public.

In comparable situations, the interposition of co-ownership has not been permitted to alter the impact of remedial liability. In equity, restrictions on a trustee with respect to dealings in trust property apply with equal force to a firm of which he is a member; and where other persons associate with a trustee in a breach of his fiduciary duties, both the trustee and his associates are held liable for the entire profits realized by the group. The Civil Aeronautics Board has treated partners as representatives of each other in enforcing its restrictions on intercorporate relationships in the industry. Under Section 249 of the Bankruptcy Act, which involves a denial of compensation as a rule-of-thumb deterrent to trading in the debtor's securities, the courts have consistently denied compensation to an attorney or other person when his firm, partner, or wife has purchased or sold securities of the debtor.

ARGUMENT

A Corporation, Which Has Stock Registered On a National Securities Exchange, May Recover Under Section 16(b) of the Securities Exchange Act of 1934 the Entire "Short-Swing" Profits Realized From Trading In the Corporation's Stock By a Partnership Which Has a Partner on the Board of Directors of the Corporation.

I

CONGRESS INTENDED THAT A CORPORATION SHOULD RECOVER ALL THE PROFITS MADE IN "SHORT-SWING" TRANSACTIONS OF INSIDERS

In enacting Section 16(b) of the Securities Exchange Act of 1934, Congress, by eliminating the opportunity for profit in "short-swing" transactions, intended to discourage the use of confidential corporate information for private profit, and the manipulation of corporate affairs to promote trading profits by insiders. The legislative history makes it clear that this intent encompassed partnership transactions as well as individual dealings. The nature of a partner's interest in his firm's transactions and profits prevents the remedy from being effective unless all partnership profits are required to be surrendered.

Section 16(b) of the Securities Exchange Act of 1934 ("the Act"), *supra*, p. 2, provides that "For the purpose of preventing the unfair use of information which may have been obtained * * * by reason of his relationship to the issuer," a director, officer, or large stockholder is accountable to his corporation for any profits realized from the purchase and sale or the sale and purchase, within a 6-month period, of his corporation's stock registered on a national securities exchange.

The Congressional study on which the Act was based had demonstrated the urgent need for restraints against the use of inside information in "short-swing" trading by corporate fiduciaries in the securities of their cor-

porations. As stated in a Senate report (S. Rep. No. 1455, 73d Cong., 2d Sess., 1934, at p. 55):

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.

The report (S. Rep. No. 1455, *supra* at pp. 56-58) gave numerous illustrations of how these abuses had been accomplished through personal holding companies or pools in which a prominent part was played by large investment banking firms and their individual members, who were either directors themselves or collaborated with corporate fiudciaries. Not only was this activity unfair to the investing public, because the insiders had information not available to those with whom they traded, but the unrestricted trading of insiders led to deliberate manipulation of the affairs of their corporations for the purpose of enhacing their personal profits without regard to the effect on the corporation. Thus, it was found (S. Rep. No. 792, 73d Cong., 2d Sess. (1934) at p. 9):

> In a particularly glaring instance, the chairman of the executive committee and another director participated in a pool organized to trade in the stock of their company when the stock was paying no dividends. During the operation of the

> pool, which continued for a period of 2 years, they caused the company to resume the payment of dividends, more than 25 percent of which were received by the pool participants. These dividends were paid during the pool's operation in spite of the fact that the company's earnings were not sufficient to meet them and part of its surplus had to be diverted for that purpose. In another case, the president of the corporation testified that he and his brothers controlled the company with a little over 10 percent of the shares; that shortly before the company passed a dividend, they disposed of their holdings for upward of $16,000,000 and later repurchased them for about $7,000,000, showing a profit of approximately $9,000,000 on the transaction.

Section 16 of the Act was the means adopted by the Congress to put an end to such practices. Under Section 16(a), Appendix, *infra*, p. 26, the officers, directors and ten-percent stockholders of corporations with equity securities registered on a national securities exchange are required to file with the Securities and Exchange Commission reports showing their ownership of such securities and, on a monthly basis, all changes in ownership. Under Section 16(b) profits realized by these insiders from trading in such securities within a 6-month period are recoverable by the corporation without proof of the actual use of inside information and, in fact, even if it is proved that the person had no inside information whatever.

The court below stated in *Smolowe* v. *Delendo Corporation*, 136 F. 2d 231, 239, certiorari denied, 320 U.S. 751:

> We must suppose that the statute was intended to be thoroughgoing, to squeeze all possible

> profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty.

The decision below virtually defeats this intention. If recovery were limited to the portion of the profit applicable to the partner-director, as the court below held, an investment banking firm with 20 equal partners, no two of whom were officers or directors of the same corporation, could use inside information in short-swing trading ad infinitum and never have to disgorge more than five per cent of its profits. As to Lehman Brothers for example, the only effect of Section 16(b) would be to shave a small percentage of its profits on short-swing transactions. The larger the firm, the smaller, on the average, the reduction of profits will be. But the very size of a firm increases its opportunities for directorships and for greater exploitation of inside information.

Even from the point of view of the individual director, the requirement that he disgorge only his share of the profits is not effective. Its weakness does not depend upon the partnership directly reimbursing him for his loss, although it would be difficult to prevent it from doing so. Without direct reimbursement, a partner will naturally profit from his firm's insider transactions since he will share in the profits of the trading in securities of corporations in which his partners are directors. Thus, while he has to surrender the profits from trading in securities of his corporation, he will be compensated by receiving his proportionate share of the profits in other transactions when one or another of his partners may have to make the sacrifice for the com-

mon good. These consequences led Judge Clark to observe, in effect, that Section 16(b) should be repealed if the decision of the majority below is allowed to stand. He stated (R. 202-203) that the most serious vice of this holding

> * * * is the unfair discrimination it builds into an important remedial statute—a discrimination substantially eliminating the great Wall Street trading firms from the statute's operation. So great is the unfairness of the result that, notwithstanding its remedial nature, the statute, it would appear, should not stand unless its judicially discovered defects can be corrected. * * *

The prevalence of partners of investment banking firms on the boards of directors of the country's large corporations is not mere coincidence.[4] Rather, it is the result of the deliberate effort of investment banking firms to establish close relationships with the issuers of securities. As was noted in *United States* v. *Morgan,* 118 F. Supp. 621, 652 (S.D. N.Y.), "the competition for business by investment bankers must start with an effort to establish or continue a relationship with the issuer," and the facts indicate that Lehman Brothers placed a partner on the board of Tide Water for this purpose (see pp. 3-4, *supra*).[5] Membership on boards of directors is intimately related to the business of investment banking, for it is a most effective means of establishing a close relationship. Thus, to disregard

[4] These firms, like much of the securities industry, are customarily organized as partnerships. See H. Rep. No. 1278, 85th Cong., 1st Sess. (1957) at pp. XV, 74-81).

[5] The trial judge concluded that (R. 153a) "there was no evidence that the firm of Lehman Brothers deputed Thomas to represent its interests as a director on the board of Tide Water." Ordi-

the relationship of the Lehman directorships to the business of the firm is to discount a significant portion of the firm's goodwill. While the primary purpose of an investment banking firm in placing its partners on the boards of corporations may be to obtain underwriting business, it cannot be assumed in the light of the text and legislative history of Section 16(b) that a firm, which is also engaged in the business of trading in securities, will ignore in its trading activities the inside information obtained from partner-directors.

As we have seen, Congress in enacting Section 16(b) was aware of the prominence of the investment banking firms and their members in the pools organized for the specific purpose of profiteering with the use of inside information. It was this result which led Judge Clark to state (R. 186-187, 189):

> I think the principle is anomalous in granting exemption in the very cases where the incentive to take insiders' profits is strongest as a part of a trading firm's normal business and where exception is the most difficult to understand.
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> * * * the exemption of these firms would be hard to explain to the ordinary small-scale director not

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narily, findings of fact will, if supported by the evidence, be accepted by a reviewing court. However, where the finding is in truth a conclusion, the reviewing court is free to draw its own conclusions from the basic facts which frequently are actually not in dispute. Cf. *United States* v. *DuPont*, 353 U.S. 586, 598.

The court in ***Morgan*** further noted (118 F. Supp. at 716):

> Lehman Brothers, together with Goldman Sachs, was a leader in the pre-Securities Act period in developing directorship relations with its customers. And, with the development of the Industrial Department of Lehman Brothers, these directorships became an important feature of Lehman Brothers' method of servicing its customers.

so exempt and indeed to the investing public generally.

Even more anomalous is the color of legality that the holding below lends to the very abuses which Congress sought to eliminate. Partnership law requires each partner to render to the other partners full information on all matters affecting the partnership business.[6] In the case of investment banking firms, the partnership business usually includes trading in securities. If short-swing trading by a partnership in securities of a corporation of which a partner is a director were to be sanctioned by this Court, the disclosure of inside information which offers profit-making possibilities to the partnership would be transformed from a vice which Congress condemned to a duty of the partner-director. This result would be completely at variance with the legislative intent of the broadly remedial provisions of Section 16(b), a result this Court should avoid even "sacrificing, if necessary, the literal meaning in order that the purpose may not fail." *Ozawa* v. *United States*, 260 U.S. 178, 194. See also *United States* v. *Public Utilities Commission of California*, 345 U.S. 295, 315; *United States* v. *American Trucking Associations, Inc.*, 310 U.S. 534, 543.

The court below adopted the district court's finding that the partnership trading was not based on inside information (R. 177) and concluded that accordingly it need not determine "whether the result might be different had Thomas caused the firm to enter the Tide Water venture" (R. 181). This is an approach which Judge Clark accurately characterized as forcing "the

[6] See N. Y. Partnership Law, Section 42, which is identical with Section 20 of the Uniform Partnership Act.

very step which we felt Congress had avoided, namely, a 'subjective standard of proof, requiring a showing of an actual unfair use of inside information'" (R. 188). It was precisely because of the difficulties of proof of reliance upon inside information that Congress determined to enact Section 16(b) as a "rule of thumb."[7] Similar difficulties of proof exist as to whether a partner has advised other members of his firm of inside information. It is unlikely that the same Congress which took a prophylactic approach in framing Section 16(b) so as to avoid the practical problem of proving whether information was in fact used by an insider intended that the equally difficult problem of proving what goes on between partners in an investment banking firm was not to be solved by the same statute.

II

SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934 MAY PROPERLY BE INTERPRETED TO COMPEL SURRENDER OF ALL THE PARTNERSHIP PROFITS

The courts below decided against liability for the full amount of the profits because they believed that the language of Section 16(b) prevented that result. In their view the partnership itself was not liable to

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[7] See Hearings Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., pursuant to S. Res. 84, 72d Cong. and S. Res. 56 and S. Res. 97, 73d Cong., 2d Sess. (1934) at p. 6557. Early drafts of the bill which ultimately became the Securities Exchange Act contained a provision for recovery of "short-swing" profits realized by anyone proved to be acting on the basis of inside information. This provision was dropped from final drafts because of anticipated difficulties of enforcement. See Hearings Before the Senate Committee on Banking and Currency, *supra*, at pp. 6560-6561; Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. (1934), pp. 135, *et seq.*; *Smolowe* v. *Delendo Corporation*, 139 F. 2d 231, 236 (C.A. 2).

account because it was not a "director"; and the director, Mr. Thomas, was not required to account because he did not "realize" the partnership profits. Neither of these objections is valid.

1. Section 3(a)(9) of the Securities Exchange Act defines the term "person" to include a "partnership." The intent of this definition is, of course, to treat a partnership as an entity subject to regulation, rather than as merely a number of persons acting in concert. Thus, when restrictions are imposed on, or liability exacted from, "persons," the law applies equally to partnerships as such, rather than solely to their individual members. The recovery of insider profits directed against stockholders holding a ten percent interest in a corporation is equally applicable to partnership holdings. The partnership and its members are inseparable; therefore the partnership is considered the insider.

A like construction should be given the Act with respect to the application of Section 16(b) to profits by directors. The essence of Section 16(b) liability described above requires that the partnership itself be treated as the real insider. It is the partnership's expertise which is ordinarily made available to the corporation, and it is the partnership which profits from the business relationship established. While it is quite true that under corporate law only natural persons may be directors, for the purpose of Section 16(b) we are not concerned with corporate law, but with the practical problem of protecting the public interest against short-swing trading by insiders. Therefore, when a member of a partnership holds a directorship with the knowledge and consent of his firm, it is entirely

reasonable to consider the partnership as the "director" for the purposes of Section 16(b).

Since Mr. Thomas accepted the directorship in Tide Water with the knowledge of his partners; since such an action by a partner of Lehman Brothers was not an occasional or isolated event, but entirely consistent with the business practices of the firm; and since advising and representing such industrial concerns as Tide Water in their financial affairs was an important part of Lehman Brothers' business, Mr. Thomas must, as a matter of law, be considered to have been acting within his authority. As we have noted, the lower courts' determinations to the contrary are essentially legal conclusions. See footnote 5, *supra*, p. 12. In these circumstances Mr. Thomas and the partnership are inseparable for the purposes of Section 16(b) as a matter of law. We do not have to consider what the situation would have been had Mr. Thomas been acting in a field unrelated to the partnership business and without its knowledge.

Judge Learned Hand, concurring in *Rattner* v. *Lehman*, 193 F. 2d 564 (C.A. 2), which involved a holding similar to that below, was troubled by the possibility of the situation where a partner is deputized by his partnership to serve on a corporate board of directors. He stated (p. 567):

> * * * but I wish to say nothing as to whether, if a firm deputed a partner to represent its interests as a director on the board, the other partners would not be liable. True, they would not even then be formally "directors"; but I am not prepared to say that they could not be so considered; for some purposes the common law does treat a firm as a jural person.[9]

We believe it is unnecessary that there be a formal deputization for this result to obtain.

In view of the fact that the sanction of Section 16(b) is admittedly designed as a rule of thumb to make unnecessary the proof of the existence of inside information in particular cases, it is entirely reasonable to apply the same rule of thumb to a partnership situation without specific proof that the partner was installed as a director to aid his partnership or that he transmitted inside information to his associates.

2. Regardless of the liability of the firm as such, we urge that in any event Mr. Thomas should be held

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[9] At the time of the *Rattner* case the Commission's Rule X-16a-3 implementing the reporting requirements of Section 16(a) allowed a partner-director to report only that amount of the equity securities of his corporation held by his partnership which represented his proportionate interest in the partnership. The *Rattner* litigation served to focus the attention of the Commission on the easy evasion of Section 16(b) available where full partnership profits from trading are not reported, and changes in this rule were being considered even before the litigation was completed. The rule, 16a-3, 17 CFR 240.16a-3 (1961 Supp.), was subsequently amended to require that a partner-director report the entire amount of the equity securities of his corporation held by his partnership. See Securities Exchange Act Release No. 4754 (1952). These requirements have now been incorporated into the instructions for the use of Form 3 adopted by the Commission for reports required to be filed pursuant to Section 16(a).

liable for the entire profits from the transactions. All partners are co-owners of all property which is purchased with firm funds. Purchases and sales of securities by the partnership are in legal effect purchases and sales by all of its partners.[9] While the profits of the enterprise may be divided among the partners in any proportions upon which they agree, this agreement cannot be permitted to control the issue of the extent of a partner's liability. Just as the courts below refused to permit a waiver of profits from the particular transactions to control liability, so, on a parity of reasoning, the arrangement that 96 per cent of the profits should go to others should similarly not be controlling.

As Judge Clark observed (R. 187-188):

> I submit that on a literal *legal* reading of the statute, Thomas was co-owner with all the other partners of the Tide Water stock when bought and of the profits when sold, and that Thomas stood at all times legally charged with full knowledge of what was going on in his firm, just as the other partners had like knowledge. Further, I do not doubt that in any ordinary well-run partnership, the practical facts of life actually coincide with these legal facts, and that one partner either actually knows what is going on in his group or is content to leave action to his colleagues. In any event, the legal situation seems clear—so much so that in my view co-owners cannot be excluded from

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[9] New York Partnership Law, Section 51, which is identical with Section 25 of the Uniform Partnership Act.

the operation of the statute without a serious distortion of its terms.

The result reached in *Walet* v. *Jefferson Lake Sulphur Co.*, 202 F. 2d 433 (C.A. 5), certiorari denied, 346 U.S. 820, points in the same direction as the reasoning employed by Judge Clark, although it dealt with husband and wife ownership in a community property state, rather than with ownership by a partnership. In *Walet*, even though only the husband was a director of the issuing corporation and the wife owned a half interest in the stock under community property law, the entire short-swing profits of both husband and wife were recovered under Section 16(b). The wife was no more a director of the issuing company in that case than were Mr. Thomas' partners directors in Tide Water.[10]

III

IN COMPARABLE SITUATIONS THE INTERPOSITION OF CO-OWNERSHIP HAS NOT BEEN PERMITTED TO ALTER THE IMPACT OF REMEDIAL LIABILITY

The courts have repeatedly shown "[u]ncompromising rigidity" in dealing with evasion of fiduciary duties; their aim is to insure that "the level of conduct for fiduciaries [be] kept at a level higher than that trodden by the crowd," *Meinhard* v. *Salmon*, 249 N.Y. 458, 464. Thus, restrictions on a trustee's dealing with the trust apply with equal force to a firm of which he is a member. *Magruder* v. *Drury*, 235 U.S. 106, 118-120;

[10] To the extent that the opinion in *Walet* is predicated upon the right of a husband to control a wife's half interest in community property its precedent value here is weakened but that right is somewhat analogous to the right of each partner to bind all other partners in any action he undertakes in the name of the partnership.

Higgins v. *Shenango Pottery Company*, 279 F.2d 46 (C.A. 3) certiorari denied *sub nom. Zahniser* v. *Higgins*, 364 U.S. 899; *In re Hallenback's Estate*, 122 F. Supp. 212 (D. D.C.); *Burr* v. *Contenti*, 102 N.J. Eq. 41, 43; *Hornor* v. *New South Oil Mill*, 130 Ark. 551, 558. And in *Jackson* v. *Smith*, 254 U.S. 586, where nonfiduciaries knowingly associated with a trustee in purchasing property of the trust, this Court held the trustee and his associates jointly and severally liable for all the profits realized by the joint venture. See also *Irving Trust Company* v. *Deutsch*, 73 F. 2d 121 (C.A. 2), certiorari denied, 294 U.S. 708.

In *Lehman* v. *Civil Aeronautics Board*, 209 F. 2d 289 (C.A. D.C.), certiorari denied, 347 U.S. 916, the court sustained the determination of the Civil Aeronautics Board that partners of Lehman Brothers who served as directors of air carriers, other common carriers, or other companies engaged in the aeronautics business were representatives of each other, an interlocking relationship generally prohibited by Section 409(a) of the Civil Aeronautics Act of 1938. The court there noted that the partners feel "free to solicit" security underwriting and merger negotiation services for Lehman Brothers "who have been employed for these purposes not infrequently by Section 409(a) companies" (209 F. 2d at 293). Accordingly, it concluded: "This is representation within not only the language but the meaning of the statute" (209 F. 2d at 294).

In *Mosser* v. *Darrow*, 341 U.S. 267, two key employees of a trustee of an estate in reorganization under the Bankruptcy Act profited from trading in the securities of the debtor. This Court held the trustee, who permitted the trading, liable for their profits, stating that equity would have deprived him of the

profits had he traded, and that "delicate inquiries" as to his relationship with his employees should be avoided. It stated (341 U.S. at 271-272):

> These strict prohibitions would serve little purpose if the trustee were free to authorize others to do what he is forbidden. While there is no charge of it here, it is obvious that this would open up opportunities for devious dealings in the name of others that the trustee could not conduct in his own. The motives of man are too complex for equity to separate in the case of its trustees the motive of acquiring efficient help from motives of favoring help, for any reason at all or from anticipation of counter-favors later to come. We think that which the trustee had no right to do he had no right to authorize, and that the transactions were as forbidden for benefit of others as they would have been on behalf of the trustee himself.

Evasions of the "rule of thumb" [11] embodied in Section 249 of Chapter X of the Bankruptcy Act, 11 U.S.C. 649, which is comparable to the "rule of thumb" here involved,[12] have not been tolerated. Section 249 provides that "[n]o compensation or reimbursement shall be allowed to any committee or attorney, or other person acting in the proceedings in a representative or fiduciary capacity, who * * * has purchased or sold * * *

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[11] See statement of Commissioner (now Justice) Douglas in Hearing before the House Committee on the Judiciary on H.R. 8046, 75th Cong., 1st Sess. (1937), p. 184:

> We visualized a lot of administrative difficulties in determining in a particular case whether or not actual inside information was used, and so we decided that the best practical way of doing it was to broaden the base a little bit and establish a rule of thumb and follow the pattern of the *Paramount case* and the *Republic Gas case*.

[12] See footnote 7 on page 15.

stock" of the debtor. As in the case of Section 16(b), Congress enacted Section 249 to guard against the possible conflicts of interest arising from trading on the basis of inside information and determined that its provisions must apply regardless of whether in a particular case actual injury or use of inside information could be demonstrated. Although Section 249 by its literal terms restricts trading only by "person[s] acting * * * in a representative or fiduciary capacity," the courts have consistently invoked its provisions to bar compensation to an attorney or other person when his firm, partner, or wife has traded in securities of the debtor. See *Surface Transit, Inc.* v. *Saxe, Bacon & O'Shea*, 266 F. 2d 862, 868 (C.A. 2); *In re Central States Electric Corp.*, 206 F. 2d 70, 71-72 (C.A. 4), certiorari denied *sub nom. Henis* v. *Egan*, 346 U.S. 899; *In re Reynolds Investing Company*, 130 F. 2d 60 (C.A. 3); *In re Los Angeles Lumber Products Company*, 37 F. Supp. 708 (S.D. Calif.); *In re Inland Gas Corporation*, 73 F. Supp. 785, 791-792 (E.D. Ky.); *In re Midland United Company*, 64 F. Supp. 399, 416-417 (D. Del.). See also *In re Mountain States Power Company*, 118 F. 2d 405, 407-408 (C.A. 3). Cf., *Securities and Exchange Commission* v. *Dumaine*, 218 F. 2d 308, 312-316 (C.A. 1), certiorari denied, 349 U.S. 929, involving the comparable provisions of Rule 62 under the Public Utility Holding Company Act of 1935. As stated in *In re Los Angeles Lumber Company*, where it had been contended that Section 249 did not bar compensation to the firm or innocent partners thereof because of trading by one partner in the bonds of the debtor (37 F. Supp. at 711):

> The court feels that in a situation such as this, each member of a law firm should share the respon-

sibility for the individual acts of another partner or other partners. To construe Section 249 otherwise would largely destroy its effectiveness. The relationship between partners is too close to make it possible to insure that compensation allowed to an innocent partner may not ultimately benefit a guilty partner, directly or indirectly. If Section 249 were to be construed as suggested, it might be possible to work out evasions of its provisions whereby one partner traded and another did legal work.

Unlike Section 249 of Chapter X of the Bankruptcy Act, the sanction of Section 16(b) cannot have the harsh effect of depriving a fiduciary of compensation earned by years of otherwise devoted labor.[13] All that is sought here is recovery of profits from a short term employment of capital—profits which Congress has determined must inure to the corporation to maintain the integrity of the fiduciary relationship between the corporation and its officers, directors and controlling shareholders.

CONCLUSION

For the foregoing reasons the judgment of the ~~dis-trict~~ court below should be reversed and the cause remanded for entry of judgment against the respondents for the entire

[13] See *e.g.*, *In re Third Avenue Transit Corporation*, 159 F. Supp. 440, 443-444 (S.D. N.Y.), *affirmed sub nom. Surface Transit, Inc.* v. *Saxe, Bacon & O'Shea*, 266 F. 2d 862 (C.A. 2).

profits realized by the partnership from the short-swing transactions in the stock of Tide Water.

Respectfully submitted,

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August 1961.

APPENDIX

Section 16 of the Securities Exchange Act of 1934.
48 Stat. 896. 15 U.S.C. 78p

DIRECTORS, OFFICERS, AND PRINCIPAL STOCKHOLDERS

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent

jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

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